# AMERICAN BAR ASSOCIATION
# SECTION OF BUSINESS LAW

## COMMITTEE ON CORPORATE LAWS

## REPORT ON SOUTH AFRICAN COMPANIES ACT NO. 61 OF 1973 AND RELATED LEGISLATION

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# SUMMARY OF OUR MISSION

# PART I: SUMMARY OF OUR MISSION

## INTRODUCTION

At the invitation of the South African Companies Registration Office ("SACRO") of the Department of Trade and Industry of the Government of the Republic of South Africa, a team of five American lawyers (the "Team") visited South Africa from April 29 through May 12, 2001. The Team was sponsored by the Agency for International Development of the Department of State of the Government of the United States ("USAID"). All of the members of the Team are present or former members of the Committee on Corporate Laws (the "Committee") of the Section of Business Law of the American Bar Association. The Committee is roughly analogous to the Standing Advisory Committee on Company Law in South Africa. (Biographies of the Team members are attached as Appendix A.)

As a matter of policy of the American Bar Association, we point out that the views expressed herein are those of the Team. They are not and do not purport to be an official position of the American Bar Association, the Section of Business Law or the Committee on Corporate Laws.

The primary responsibility of the Committee is the continuous review and revision of the Model Business Corporation Act (the "Model Act"), which was first published by the Committee in 1950 as a model general corporation statute. The Model Act has been adopted substantially in its entirety by 24 of the 50 states as their general corporation statute and seven other states have corporation statutes based on the 1969 version of the Model Act. In addition, many other states have adopted selected provisions of the Model Act. The Model Act and its Official Comment are often cited in judicial opinions, even in states that have not adopted the Model Act.

The Committee on Corporate Laws consists of a chair, appointed by the Chair of the Section of Business Law for a four-year term, and 25 members, one of whom is the Reporter to the Committee and 24 of whom serve for staggered six-year terms, appointed by the Chair of the Section on Business Law on the recommendation of the Chair of the Committee. Committee members have included partners in law firms throughout the United States, general counsels of major corporations headquartered in the United States and law and business school professors. Past members have also included federal and state judges (including the current Chief Justice of the Supreme Court of Delaware), Commissioners and the former General Counsel of the United States Securities and Exchange Commission ("SEC") and a former Director of Central Intelligence.

We regard this Report as only a first step in a continuing dialogue with SACRO and others in the South African government and the private sector. We hope that this outline of our conclusions, based on our visit and review, will lead to continued discussions between the Team and our colleagues in South Africa, as well as to further visits both in South Africa and in the United States. (After our visit, we learned that SACRO may be reorganized and renamed.)

## WHAT WE WERE ASKED TO DO

We were asked by SACRO and the Department of Trade and Industry of South Africa:

- to examine the process whereby companies and close corporations are formed under the Companies Act no. 61 of 1973 (the "Companies Act") and the Close Corporations Act no. 69 of 1984 (the "Close Corporations Act"), and to give our views on how SACRO can modernize and streamline the company formation process;

- to review the post-formation document lodgment process at SACRO under the Companies Act and the Close Corporations Act and to give our views on how this process can be simplified and streamlined; and

- to analyze possible amendments to the Companies Act and the Close Corporations Act for consideration in connection with a wide-ranging review of these statutes now underway in South Africa.

We have approached the Companies Act and related legislation with respect for South Africa's sophisticated financial and legal infrastructure, with an awareness of its unique history, traditions and culture, and with a sincere desire to share our own experiences, recognizing that we can surely learn from each other. Our observations and recommendations are those of interested and sympathetic friends who are glad to be helpful in any way we can but who recognize that the decisions to be made are South Africa's alone.

## WHAT WE DID

Prior to our departure, each member of the Team reviewed the Companies Act, the Close Corporations Act, the Insider Trading Act and related materials, including CILLIERS & BENADE, CORPORATE LAW (3d ed. 2000) and materials from SACRO.

During our two weeks in South Africa, we met with over 50 people, including Justice Richard Goldstone, Registrar Felix Malunga and his senior staff, U.S. Ambassador Delano Lewis and senior members of his staff, Neal Cohen and other senior representatives of USAID in South Africa, practicing lawyers, corporate law professors, accountants and business people. We were very ably assisted, and our meetings and travel arrangements coordinated, by Dr. Michael Anderson of the USAID's contractors, Nathan Associates, and by Nompilo Mali of USAID. Adv. H.P. "Flip" Dwinger, our liaison with SACRO, accompanied us to most of our meetings and participated in our discussions. His encyclopedic knowledge of South African companies history, law and practice and his contacts in the government and business communities were invaluable. We also benefited greatly from the advice of Professor Robert C. Williams, of the University of Natal School of Law, who participated in many of our meetings and assisted in the preparation of this report. (A partial list of the people we met is attached as Appendix B.) Finally, we appreciate very much the careful review of this Report, including many good suggestions, by Trevor Norwitz, a native son of South Africa and currently a partner at the New York law firm of Wachtell, Lipton, Rosen & Katz, and by Thomas J. Kim, a lawyer at the Washington, D.C. office of Latham & Watkins.

We reviewed extensive documentation regarding SACRO's organization and future plans, and we visited all SACRO operating units in Pretoria, observed their operations and interviewed key employees. We found that the senior officials of SACRO were extremely receptive to what we could tell them of our experience with their counterparts in the U.S., the secretaries of state of the various states and the SEC. In addition to our meetings with individual SACRO officials and employees, SACRO arranged for a seminar in which we and the senior and middle managers of SACRO were active participants. At this seminar, these managers told us about their experiences and problems, and we gave two presentations to which the managers and employees responded with their own questions and comments. Frank Balotti spoke on the operation of the Secretary of State's office in Delaware, including the filing of documents at both the pre-incorporation and post-incorporation stages, and John Olson gave a presentation on the jurisdiction and operations of the SEC and its development and deployment of its Electronic Data Gathering, Analysis and Retrieval ("EDGAR") filing system.

We found this dialogue extremely useful in understanding the challenges SACRO faces and in formulating our recommendations.

## WHAT WE LEARNED

We necessarily reviewed South Africa's companies laws in the context of our experience with our own corporate laws and from our point of view as American lawyers. In the U.S., the formation of corporations and other forms of business entities, and the regulation of their internal affairs, is generally governed by state law. The state has little substantive input or participation in the entity-formation process and its role is largely administrative. The offering, selling and distribution of securities issued by those entities is jointly regulated by state and federal laws, although federal regulation generally governs the sale of publicly traded securities. Matters related to the governance of securities exchanges and the regulation of financial institutions are governed by separate federal statutes administered by specific federal agencies.

While there are some notable and unique aspects of our corporate laws that derive from the relationship between our state and federal governments, we believe that our corporate and securities laws provide a useful point of comparison to South Africa. These U.S. laws have been continuously drafted and revised to enhance capital formation, encourage effective corporate governance, protect investors, facilitate corporate transactions, minimize transaction costs and, ultimately, promote public confidence in corporations and the economy. The means to those ends may differ – and do differ – among nations, but we believe we share the same objectives. Further, we recognize that all legislation – including company statutes, which some incorrectly assume to be dry and technical – does and should reflect the history, traditions, values and culture of the people enacting it.

While we offer more detailed recommendations concerning particular provisions of the Companies Act in Part II and the Close Corporations Act in Part III, our principal observations concerning the Companies Act, the Close Corporations Act and SACRO's operations are as follows:

- The Companies Act is highly creditor-oriented. This is similar to the early corporation statutes in the U.S. More recently, however, the Model Act and Delaware and other state company or corporations laws have moved away from a focus on creditor protection because banks and other creditors – in the U.S. and elsewhere – have developed more effective, flexible and debtor-specific ways of protecting their interests than corporation statutes, such as contractual covenants and acceleration provisions, collateral, cash flow requirements, personal guarantees and credit insurance. As creditors have grown less concerned about corporation law as a source of protection, legislators have eliminated many of the early creditor-protective statutory provisions. These developments are consistent with an evolution in the U.S. and elsewhere toward flexibility and greater latitude for parties to establish their own terms of relationship.

- In part because of its creditor-protection focus, the Companies Act requires the collection of large amounts of information and the lodgment of many forms with SACRO. Much of this information is of questionable utility to the commercial and investment communities. In addition, the large number of lodgments at SACRO (over 8,000 per day) currently results in delays in processing and in the availability of lodged documents. As a result, South Africans in the business and financial communities told us that they do not rely on the information filed at SACRO as being accurate or up-to-date. The problems of accuracy and currency of lodged materials are exacerbated by the fact that SACRO has neither the staff, financial services nor program to discover delinquencies and inaccuracies in lodgments or to pursue violators. In short, we understand that there is little effective enforcement of the lodgment requirements of the Companies Act and the Close Corporations Act. Moreover, in South Africa, the doctrine of constructive notice *vis-à-vis* documents lodged with SACRO means that notice can become a significant issue in corporate litigation if lodgments are not accurately or timely processed.

- The Companies Act has many highly formalistic requirements of uncertain benefit, making it comparatively difficult and burdensome to form a corporation, with no apparent policy reason as to why that should be the case. The U.S. corporate formation process has evolved over the years from a system in which each corporation was separately chartered by act of the state legislature to today's administrative approach in which the state plays only a ministerial role. As a result, any layperson can form a corporation and only one person is typically required to sign as the incorporator. Statutory and administrative changes in recent years have essentially automated the formation process and, in many instances, formation can be done entirely through electronic filings. In addition to simplifying the incorporation process, states have generally reduced or eliminated statutory restrictions on corporate governance, leaving many issues to be resolved as a matter of contract between shareholders and the corporation and, in the case of publicly traded companies, to be governed by stock exchange listing standards.

- During our meetings, we heard from many South Africans that South Africa is moving, and needs to continue to move, from a highly concentrated economy significantly oriented toward extractive activity to a more diverse economy capable of providing goods and services to external as well as internal markets. South Africa is also continuing to wrestle with currency exchange controls, which generally tend to discourage foreign investment.

- There is limited protection for equity investors under the Companies Act. Notably, equity investors have no direct right of access to the courts to enforce reporting or notice requirements. Various sections of the Companies Act provide remedies for particular wrongs. Notable among these are a statutory derivative action which (although the proceedings are initiated by a member) is available to a company to redress a wrong done to it (Section 266); a remedy available to shareholders for acts or omissions of the company that are unfairly prejudicial, unjust or inequitable toward them (Section 252); personal liability for some or all of the debts of a company, which the court is empowered to impose on persons (including but not limited to directors) who were knowingly party to fraudulent or reckless trading by the company (Section 424); and civil liability for misstatements in a prospectus (Section 160). The Close Corporations Act contains provisions analogous to the aforementioned Sections 252 and 424 of the Companies Act (See Section 49 and Section 64 of the Close Corporations Act). The Close Corporations Act also has a wide-ranging remedy for a "a gross abuse" of the juristic personality of a close corporation (Section 65).

  However, the disincentives to litigation in South African courts, such as high legal costs, the general rule that a losing litigant must pay the legal costs of the successful party, the unavailability of class actions and contingency fees and the protracted nature of litigation, may diminish the practical effectiveness of these statutory provisions. It is, of course, difficult to assess such effectiveness, given that litigation is often settled before judgment (and some such settlements may involve acceptance by corporate delinquents of liability for damages to shareholders) and that not all judgments are published in the pages of the law reports. But it is striking, for example, that there seems not to have been a single reported judgment on Section 160, which deals with liability for untrue statements in a prospectus. In the U.S. and other major capital markets, corporate law is moving in the direction of increased protection for equity investors, especially as more capital is being furnished in the form of equity rather than debt. The touchstones for attracting investment have become transparency of financial results and significant corporate developments and accountability of managers to investors. A clear and comprehensive set of laws providing the basic protections of transparency and accountability is essential in today's increasingly integrated global capital markets. Even for purely local capital formation, such investor protection is necessary to give confidence to the small- and medium-sized investor.

- The staff at SACRO is impressive, motivated, focused and energetic. We were particularly impressed with the senior management of SACRO, who are entrepreneurial and customer-oriented. We were also impressed with the leadership of Registrar Malunga and his commitment to client service.

- SACRO wants to convert to a fully electronic system and to deploy this system regionally, with computers available in post offices throughout South Africa. Registrar Malunga's plan to extend SACRO's services to rural and outlying areas by installing computer terminals in post offices and employing the services of deputy registrars from the private sector to facilitate their use will, we believe, help to lessen the development of a "digital divide" between those who have access to technology and those who do not. This is an ambitious, costly plan but may result in long-term benefits. SACRO's transition from a paper to an electronic system will be difficult, however, because, among other things, both the present paper-based system and the new electronic system will have to operate concurrently for some years. SACRO's existing archive of documents will also have to be scanned and archived, which, we understand, is already underway. We believe that the benefits are probably worth the effort and cost. Delaware has already made this conversion and the results there are impressive. Moreover, we understand that under South Africa's current labor law dispensation, SACRO has had problems hiring temporary staff for extended periods to alleviate the bottleneck.

- The delays in processing lodged documents at SACRO, which can be exacerbated by postal delays or incomplete documents which must be returned for corrections, have two important consequences: First, in reaction to these delays, law firms and other users of SACRO's services routinely form "shelf companies" – incorporated "shells" that are reserved for future use – which adds to SACRO's workload and consequent delays, especially because the formation of these companies tends to be concentrated seasonally. Second, the law firms and others who form shelf companies charge a fee for having a company available at short notice. This economic value could be captured by SACRO if it offered a faster, expedited company formation service for an additional fee.

- SACRO has an impressive Web site (www3.dti.gov.za/sacro/), which is already more technologically advanced than the Web sites of many secretaries of state in the U.S., including Delaware's. As SACRO enables users to access requisite forms in PDF format and to complete and lodge documents electronically, the Web site will be all the more impressive. As the availability of the Web site becomes more widely known, more operational efficiencies should be realized. One-time data capture and automated routines should reduce the need for lengthy forms. We believe that, as SACRO improves its services, it can increase its fees, particularly for expedited services, and thus increase its economic contributions to the South African Government. Indeed, SACRO's annual budget is R14 million, from which it produces annual revenue of R66 million. Reorganization and modernization of SACRO may well be fiscally justified if, as we suggest, SACRO charges increased fees for expedited services.

- We understand that some prominent commentators in South Africa are considering the advisability of a substantial revision of the Companies Act and the Close Corporations Act. We agree that this is a good idea for a statute which, for the most part, has not been revised in 30 years, and particularly so in light of the new political and economic environment. Our experience is that periodic revisions are not only desirable but necessary to meet changing policy goals, economic conditions and technological progress. Our Model Act, first introduced in 1950, was subjected to a substantial revision in the 1980s, a process that took five years. Likewise, Delaware, Maryland, Ohio and other major states in the U.S. have completely redrafted their corporate codes in the last three decades. In most cases, these revisions took several years. While we take no position on the question as to whether any new legislation should follow the Commonwealth, U.S. or some other model or take a uniquely South African approach, we believe that South African authorities should decide on the principal objectives that they want the Companies Act and the Close Corporations Act to serve and then review and draft legislation consistent with these policy goals.

## OUR GENERAL RECOMMENDATIONS

In making these recommendations, we focus on what we regard to be the most important substantive issues of company law and stay away from particularized drafting. There are substantive provisions of the Companies Act and the Close Corporations Act that we have not addressed. We are ready and willing to discuss these provisions and any related or unrelated issues of drafting, as well as our recommendations, as may be desired.

Running throughout our recommendations are three recurring themes for consideration:

- Reduction of the number of formalistic requirements that have little or no benefit;
- Very much related to the first, reduction in the number of required lodgments; and
- Decriminalization of non-compliance with many provisions of the Act.

As regards company formation, we recommend that:

- There should be some form of expedited service, at a higher fee than for regular processing, involving a separate electronic queue available to all who wish to use it (not just law firms and professional agents), for both name reservation and company formation.

- There should be a reduction in the number of steps necessary to form a company. For example, name reservation as a precondition to forming a company could be abolished.

- The forms required to be lodged at SACRO, many of which are duplicative, can be significantly consolidated. Many of these forms can be shortened, especially if the Companies Act is amended to eliminate required provisions that appear to yield little benefit. Perhaps any legislation to this end could be fast-tracked.

- Fees could be payable by electronic transfer, in cash or by check, and the need to purchase and affix revenue stamps to each lodged document eliminated.

As regards post-formation, maintenance and the responsibilities of SACRO, we recommend that:

- The number of required lodgments be reduced (for example, it should not be necessary to lodge a form whenever there is a change of directors).

- Many of the present forms can be consolidated, perhaps into a periodic filing. If detailed information is required to be lodged, it could be done annually or semi-annually. This would facilitate compliance and would reduce the number of lodgments. Under the Companies Act, SACRO has no independent way of determining when or whether a lodgment is due. Thus, even in an electronic environment, companies might not furnish the required information, and SACRO and the users of SACRO's records cannot easily or quickly determine whether company information at SACRO is timely. A semiannual or annual reporting system would greatly enhance both information reliability and SACRO's monitoring and enforcement capabilities.

- A decision as to when lodgments are needed and what information should be required should be made on the basis of materiality and with regard to different kinds of companies and close corporations. For example, a close corporation often takes no formal action until the end of the year, when its tax return is completed. Accordingly, any lodgments due to be filed by a close corporation could be required only at the end of each year.

- SACRO should review and reconsider its role in the securities offering process. At present, SACRO engages in only a limited review of prospectuses, and the Johannesburg Stock Exchange ("JSE") separately engages in a more substantive review for companies whose shares are or will be listed. For listed companies, these reviews might better be consolidated in one forum – with perhaps the JSE reviewing listed companies and SACRO reviewing unlisted companies. The assignment of responsibility for prospectus review as between the JSE and SACRO, the nature of the review and the adequacy of staff resources all need attention.

- Except for the efforts of the JSE as to traded companies, there is little or no credible enforcement of most of the criminal provisions of the Companies Act and the Close Corporations Act, including the Companies Act provisions requiring financial reports and notice of important developments – essential elements of transparency to investors. The lack of effective enforcement of the Companies Act – in addition to the absence of fiduciary duties of directors – may be having an adverse effect on attracting foreign capital. In our judgment, the system presently embodied in the Companies Act – essentially a series of penal fines for non-compliance, which are rarely, if ever, enforced – likely creates a culture of noncompliance. If enforcement is to be effective, the number of requirements imposed on companies and close corporations should be reduced to those that will be recognized as both rational and important, and these requirements should be effectively enforced. Again, moving to a scheduled periodic reporting system could be an important part of this process. Enforcement measures for SACRO should include the right to issue its own administrative orders, impose fines and obtain judicial mandates to assure compliance, and could also include provisions disqualifying companies or close corporations that are persistent violators from access to public markets or qualification for tax or other benefits. We cannot emphasize too strongly that the perception and reality of systematic and credible enforcement, particularly of investor protection laws, are essential to the creation of an attractive environment for investors, especially investors from outside South Africa, who have a wide range of investment choices. In addition, South Africa may want to consider various incentives to private enforcement of the Companies Act, such as class actions.

# PART II

## RECOMMENDATIONS WITH RESPECT TO THE COMPANIES ACT

## PART II: RECOMMENDATIONS WITH RESPECT TO THE COMPANIES ACT

Our comments and recommendations as to the Companies Act are grouped under the same headings as used in the Companies Act. As noted above, we have tried to limit our recommendations to what we considered the most important substantive issues. In addition to recommendations, we also pose various questions and observations based on our experience. (Chapter numbers follow the chapter numbers in the Companies Act.)

### INTERPRETATION

Section 1(1), definition of "debenture": We are interested in what "debenture stock" is, especially as it is not a defined term. In the U.S., a "debenture" is generally understood to be a debt instrument.

*Id*., definition of "equity share capital" and "equity shares": This definition appears to provide that this security, which in the U.S. is known as "preferred stock," with limited preferences as to dividends and as to distribution of assets upon liquidation, would not be treated as equity. How would it be treated? As debt?

*Id*., definition of "share": We note that this definition includes the terms "share capital" and "stock" and that neither of these terms is defined in the Act.

*Id*., definition of "subsidiary company" or "subsidiary": We note with admiration the sophistication of the definition of "subsidiary" contained in subsection (3).

### CHAPTER III
### TYPES AND FORMS OF COMPANIES, CONVERSIONS AND LIMITATIONS ON PARTNERSHIPS AND ASSOCIATIONS

Section 19(1)(b): What is the "guarantee" referred to in this provision – by whom and to whom is it made and for what purpose?

Sections 19(2) and 20: Is our interpretation correct that a "public company" is a "company having share capital" that is not a "private company"?

Section 19(3): Why are "companies limited by guarantee" deemed to be public companies?

Section 20: We wonder whether this statute would prohibit public issuances of debt by subsidiaries of a private company and, if so, why.

# CHAPTER IV
# FORMATION, OBJECTS, CAPACITY, POWERS, NAMES, REGISTRATION AND INCORPORATION OF COMPANIES, MATTERS INCIDENTAL THERETO AND DEREGISTRATION

Section 32: We see no purpose in requiring more than one person to form a company having share capital or a company limited by guarantee. We believe that this requirement may be a holdover from the time when, by law or practice, all subscribers to the corporation's initial sale of stock were incorporators. *Recommendation*: Permit one person to form a company having share capital or a company limited by guarantee. *See* Model Act § 2.01; Delaware General Corporation Law § 101(a).

Section 33: Modern corporate practice is not to limit a corporation to any specific objective or purpose. *Recommendation*: Add a sentence specifically permitting a company to be formed for the purpose of engaging in any lawful activity, whether or not specified in the memorandum. *See* Model Act § 3.01(a); Delaware General Corporation Law § 101(b).

Section 35: As a company may enter into post-incorporation contracts without being required to have them certified by a notary public and lodged with the Registrar, we do not understand why these requirements should be applied to pre-incorporation contracts. *Recommendation*: Delete the proviso of this section.

Section 37(1)(a): While we generally support disclosure of transactions, including loans and other financial assistance, between a company and its insiders (directors, executive officers, controlling stockholders and affiliates), *see* Model Act §§ 8.61 *et seq*. and Delaware General Corporation Law § 144, we do not understand the purpose of this provision.

*Id*., (2): While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties (including, in this case, up to two years in jail) are appropriate for this type of provision.

Section 38: Modern corporate practice is not to limit the power of a company to provide financial assistance to purchasers of shares from the company, *e.g.*, by permitting them to pay for their shares with a promissory note to the corporation. The adequacy of the consideration to be received by the company for issuance of its shares should be determined by the board of directors. *Recommendation*: Delete. *See* Model Act § 6.21(b); Delaware General Corporation Law § 152.

Sections 41 through 51: Generally, far more attention is devoted to the matter of company names than is the practice in the United States. *See* Model Act §4.01-4.03; Delaware General Corporation Law §102(a)(1). We believe that the principal statutory concerns with respect to company names are that the names (a) should correctly indicate the type of entity (*see* Section 49), and (b) should not be confusingly similar to the name of another entity formed or operating under the laws of the Republic. If it is also desired to prohibit the use of profane or other "undesirable" words (*see* Section 41), we believe that is a matter of legislative policy beyond our charge.

Section 42: While reservation of a name for limited periods of time before incorporation is permitted in most jurisdictions in the U.S., it is not required. *See* Model Act § 4.02. We believe that the mandatory pre-incorporation name registration required by Companies Administrative Regulation, 1973, Section 19(1)(b), is unnecessary. (We also question whether Regulation 19(1)(b) is authorized by the Companies Act.) As we are informed that there are approximately 1,200 name registration applications lodged at SACRO each day, each of which must then be processed, this adds significantly to SACRO's burden of work without any apparent benefit. In most jurisdictions in the U.S., the company's name is cleared as part of the process of incorporation. *Recommendation*: Delete requirement for pre-incorporation name clearance.

Section 44: We question whether a change in the company's name is important enough to require a special resolution. In Maryland, this may be done by action of the board of directors without stockholder approval but with a public filing. *See* Maryland General Corporation Law § 2-605(a)(1). In Delaware, this may be done by a "short-form" merger of a (typically newly formed) wholly owned subsidiary into the parent, with the resolution of merger adopted by the board of directors of the parent corporation and the certificate of merger providing for change of the parent corporation's name. *See* Delaware General Corporation Law § 253(b). The Model Act permits the same result. *See* Model Act ch. 11.

Sections 45 and 46: We are not familiar with these types of provisions. We question whether they are necessary or often utilized but recognize that this is probably a matter of legislative policy beyond our charge.

Section 50(1): We believe that these requirements may impose unnecessary costs on a company without any significant benefit. In particular, engraved seals are no longer required in most jurisdictions in the U.S. We recognize that requiring printing of the company's name and registration number on all of the documents mentioned in subsection (1)(c) is a matter of legislative policy. However, we note that, so far as we know, there is no similar requirement in any jurisdiction in the U.S.

Section 52(1): *Recommendation*: As noted above in connection with Section 33, consideration should be given to permitting a company to be formed for the purpose of engaging in any lawful activity, without any greater specification in the memorandum. Also, you may want to consider adding the registered office and address of the company as required to be included in the Memorandum of Association.

*Id*., (2): We note that "share capital" is not a defined term. *Recommendation*: The memorandum should be required to state (a) the number of shares of stock of each class that the company is authorized to issue and (b) if the company is authorized to issue more than one class of stock, a distinguishing designation and a description of the terms, including the preferences, rights and limitations, of each class. *See* Model Act § 6.01 (which is currently being revised); Delaware General Corporation Law §102(a)(4).

Section 54(2): As noted above in connection with Section 32, we recommend permitting a company having share capital or a company limited by guarantee to be formed by only one person. In addition, we see no significant benefit to requiring the occupation and address of each incorporator and to requiring witnesses to the signature of each incorporator. *Recommendation*: Delete all of this subsection except the requirement that the memorandum be signed by the incorporator. *See* Model Act § 2.01 (Official Comment); Delaware General Corporation Law § 103(a)(1).

Section 55: As two or more holders of ten percent of the share capital have the power to call a special meeting of a company (Section 180(1)), it appears to us that a special resolution altering the provisions of the memorandum with respect to objectives and powers may be passed by the members without prior approval by the board. In every state in the U.S. of which we are aware, an amendment to the charter may be presented to the stockholders only if first approved by the board. *See*, e.g., Model Act § 10.03(a); Delaware General Corporation Law § 242(b)(1). We note, without making any recommendation, that the process by which the memorandum is amended and, in particular, whether prior board approval should be required, is a very important issue.

Section 56(3): As inclusion of the provision under Section 53(b)(relating to liability of directors) is not mandatory, we question whether judicial approval should be required for an amendment altering or removing it. We understand that the purpose of Section 53(b) was to create a special type of company for the organized professions (*e.g.*, law and accounting) that would give practitioners the benefits of incorporation, which they had long sought for tax and other reasons, but without the benefit of avoidance of personal liability, as it was considered undesirable for lawyers, in particular, to hide behind the corporate veil. We recognize that a Section 53(b) company is a special case in this regard.

*Id*., (4): *See* Section 55, above.

*Id*., (5): Does this mean that the memorandum could provide that the rights of a class of members could be altered or abrogated by the vote of members other than the members of the affected class? Some states in the U.S. (*e.g.*, Maryland – *see* Maryland General Corporation Law § 2-602) would permit this result, and some states (*e.g.*, Delaware – *see* Delaware General Corporation Law § 242(b)(2); *see also* Model Act § 10.04) would not. We recognize, of course, that shares whose terms could be altered without a vote of their holders could be more difficult to market.

Section 60(2): As with the memorandum (*see* Section 54(2), above), we see no reason for requiring every incorporator to sign the articles of association, for requiring occupations and addresses of each incorporator and for requiring witnesses to the signatures of each incorporator on the articles of association. We note that, in most of our jurisdictions, bylaws, which are the U.S. counterpart to your articles of association, may be adopted by either the board or the stockholders. Model Act § 10.20; Delaware General Corporation Law § 109(a).

Section 62: In our experience, bylaws may be amended by either the board or the stockholders. It should be noted that the articles/bylaws often contain less fundamental but nevertheless important provisions than contained in the memorandum/charter and, therefore, it may facilitate the internal governance of the company for the board to have the power to amend the articles/bylaws. *See* Model Act § 10.20; Delaware General Corporation Law § 109(a). We recognize, however, that many of the matters listed in Tables A and B to Schedule 1 would, in the U.S., be found in the statute or charter and might, therefore, not be appropriate for amendment by the board. Also, we question whether approval of amendments to the articles by members should require special resolution.

Section 63(1): In the U.S., there is generally no requirement for certification by a notary public of documents to be filed with a secretary of state or with the SEC because there is no benefit provided by such a requirement. *Recommendation*: Delete this requirement.

Section 63(2): As we recommend deletion of the concept of par value (*see* Section 74, below), we recommend developing a new basis for determining the prescribed fee other than par value or the number of authorized shares, both of which are wholly arbitrary numbers.

Section 66: We do not understand the reason for this statute. It has no counterpart in our corporate law. If you decide to amend Section 32, as recommended above, then this section could readily be deleted.

## CHAPTER V
## SHARE CAPITAL ACQUISITIONS BY COMPANIES OF OWN SHARES, SHARES ALLOTMENT AND ISSUE OF SHARES, MEMBERS AND REGISTER OF MEMBERS, DEBENTURES, TRANSFERS, AND RESTRICTIONS ON OFFERING SHARES FOR SALE

Section 73: You may want to consider linking cancellation of registration to the failure to file annual reports or to pay any required fees for some period of time rather than to whether the corporation "is carrying on business or is in operation."

Section 74. We question the continued need for the concept of par value. Par value was originally developed in the early days of corporations to insure "equitable contribution," *i.e.*, equal pro rata payment by stockholders for stock issued by the corporation. This purpose was long ago abandoned as economically unrealistic. Subsequently, par value and its corollary, stated capital (par value per share multiplied by the total number of shares outstanding), were employed as part of an equation determining whether the corporation could pay dividends or make other distributions to its stockholders. Under this equation, a corporation may not pay a dividend or make another distribution unless the sum of its assets at least equals the sum of its liabilities and its stated capital. To put it in other words, a corporation could make distributions only out of "surplus." With the development of low-par and no-par stock, this reason for par value has also evaporated. Today, it is widely recognized that par value, especially a low par value, is economically insignificant and artificial. Accordingly, in the mid-1980s, the Model Act abolished par value altogether. In its place, Section 6.40 of our Model Act substituted the equity and balance-sheet solvency tests, which we note that South Africa has also adopted as the standard for acquisition of its shares by a company (Section 85(4)) and for payments to shareholders (Section 90(2)).

*Recommendation*: Delete the concept of par value and the related concept of stated capital throughout the Companies Act. We recognize, as indicated above (Section 63(a)), that a new basis for determining the registration fee (Section 63(2)) and the share capital increase fee (Section 75(3)) will have to be developed, but we believe that preserving an economically insignificant and artificial concept such as par value solely for this purpose no longer makes sense. Moreover, it has been our experience that the continued existence of par value mistakenly leads some people to assume that it has economic significance.

Section 79: We are not familiar with this type of provision. We question the need for approval by the Minister of a matter that may be viewed as entirely contractual among the parties.

Section 80: We are not familiar with this type of provision. We question the need for legislation on a matter that may be viewed as entirely contractual among the parties.

Section 81: As discussed above (*see* Section 74), there is no economic connection between par value and the price at which shares are issued by the company, and the 1999 amendments to the Companies Act have abandoned any reliance on par value as a standard for the company's power to pay dividends or make other distributions. Accordingly, we see no reason why the company should not be able to issue shares at whatever price it can get, including a price that is lower than par value (if par value is to be retained at all -- *see* Section 74, above). *Recommendation*: Delete this section.

Section 82: For reasons similar to those discussed in connection with Section 81, above, we see no reason why a company should not be able to issue no par stock at whatever price it can get, without the requirement of approval by special resolution. *Recommendation*: Delete this section.

Section 85: We applaud the 1999 amendments tying a company's power to acquire shares of its own stock to a reasonable belief that the company is solvent in the equity sense and in the balance-sheet sense. However, we see no reason to require a special resolution as a pre-condition to such an acquisition. In the European Union, there is a requirement for stockholder approval for a corporation's purchase of its own shares. European Union, Second Council Directive (Dec. 13, 1976), art. 19(1)(a). In widespread practice, this requirement is routinely satisfied by a boilerplate resolution presented to the stockholders each year approving share repurchases for the coming year. We believe that a requirement that is so routinely and generally satisfied does not provide, if it ever did, any material benefit or protection to shareholders. In the U.S., corporations are generally authorized to acquire shares of their own stock (*see* Model Act § 6.31; Delaware General Corporation Law § 160(a)(1)), subject in some states to limitation by charter. *See* Maryland General Corporation Law § 2-310. Moreover, we note that there is no requirement for a special resolution for payments to shareholders under Section 90 (which apparently includes dividends). Since a pro rata dividend and a pro rata acquisition of shares have the same economic effect on the company, we see no reason for requiring a special resolution for the latter. In the case of non-pro rata share acquisitions, we can understand a concern for shareholder approval. However, as discussed below (*see* Section 90), we believe that the statute should permit, subject to any limitations in the memorandum, both pro rata and non-pro rata share acquisitions if approved by the board, without requirements that could delay a desirable transaction without providing significant benefit to the company or protection for shareholders. *See also* Section 87(1) (second paragraph), below. *Recommendation*: Delete Section 85(1)-(3).

It is unclear in Section 85(4)(b) whether preferences on liquidation included in the terms of preference stock would be considered as liabilities in determining the power of a company to acquire common shares. The Model Act addresses this issue by treating senior liquidation preferences as liabilities, unless the charter provides otherwise. *See* Model Act §6.40(c)(2). It would be equally plausible *not* to treat senior liquidation preferences as liabilities unless the articles provide otherwise. In Delaware, preferences are not treated as liabilities for this purpose because purchases of shares may be made, as a general rule, only from "surplus," which is defined for this purpose as assets minus liabilities and capital. Delaware General Corporation Law §154. *Recommendation*: Amend Section 85(4)(b) to address the issue of whether senior liquidation preferences should be treated as "liabilities of the company."

If the concept of par value is eliminated as we suggest (*see* Section 74 above), then subsections (6) and (7) can probably be deleted.

Section 86(1): The Model Act provides that a director who assents to a distribution in the form of an acquisition by the company of its own shares that does not meet the equity solvency and balance-sheet solvency tests is personally liable to the corporation for the amount of any improper excess payment *if* the party asserting liability establishes that in approving the distribution the director did not comply with the Model Act's statutory standard of conduct for directors. *See* Model Act § 8.33(a). In Delaware, the test is whether the directors were "willful or negligent" in approving the unlawful dividend. Delaware General Corporation Law § 174. The liability of directors provided by Section 86(1) is absolute and not subject to any requirement of non-compliance with a standard of conduct for directors. We discuss elsewhere the issue of establishing a statutory standard of conduct for directors. *Recommendation*: Whether or not a standard of conduct for directors is established by statute, consideration should be given to amending Section 86(1) to eliminate the absolute liability of directors and to require some standard of fault, *e.g.*, lack of good faith, recklessness or intent.

Section 87(1): While we note that the offering circular requirement does not apply if the share acquisition is approved by special resolution or if the shares are listed on a stock exchange within the Republic, we believe that such a requirement for any share acquisition adds unnecessary time and expense to consummating a transaction. There is no similar offering circular requirement for the acquisition of shares in the U.S.

Moreover, it is unclear from Sections 85 through 87 whether a company may acquire shares on a non-pro rata basis from shareholders, as is generally permitted in the U.S. Purchasing shares of a single shareholder or small group of shareholders without the obligation to make the same offer to all shareholders may often be advantageous to a company. For example, a particular shareholder may have reasons not generally shared by other shareholders to dispose of its investment in the company at a price favorable to the company and other shareholders. Often, the company's ability to act quickly is essential to making the acquisition (and possibly preventing the shares from falling into the hands of a potentially mischievous holder). *Recommendation*: Consider clarifying that a company may acquire its own shares without making the same offer to all shareholders pro rata.

Section 90: We generally admire the modern simplicity and flexibility of this provision. We note, however, that subsection (1) requires that payments to shareholders be authorized by the articles. We suspect that this requirement simply leads to a boilerplate provision in every articles authorizing payments to the shareholders. *See* Schedule 1, Table A, Section 84, which permits declaration (but not payment) of dividends at the annual general meeting, and Section 85, which permits interim dividends, and Table B (Sections 83, 84). *See also id*., Table A, Section 86, and Table B, Section 85, which prohibit dividends "otherwise than out of profits," which appear to be at variance with the 1999 amendment to Section 90(2) of the Act. *Recommendation*: Amend Section 90(1) to delete requirement that authorization to pay dividends be contained in the articles and provide generally that dividends may be paid by the company if authorized by the board and subject to any limitations in the articles.

Section 92(2)(a): The first word "is" apparently should be "if".

Section 93(3): We see no reason for requiring lodgment with the Registrar of the particulars of allotments of shares. There is generally no such requirement in the U.S. *Recommendation*: Delete subsections (3) and (4).

*Id*., (5): While we recognize that the issue of penalties is to a large extent a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 96(3): While we recognize penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 98(1): In light of the 1999 amendments to Section 90, we do not understand the continued reliance on "profits of the company" as a standard for redemption of preference shares. This is especially so given the fact that profits available for dividends have been interpreted as "revenue profits, that is profits earned as a result of trading activities. Divisible profit, on the other hand, can also include capital profit such as profit earned on the sale of a fixed asset, for example, land." CILLIERS & BENADE, CORPORATE LAW (3d ed. 2000) 21.05. As the power of the company to acquire its own shares (*see* Section 85, above) and to pay dividends (*see* Section 90, above) has now been tied to the equity and balance-sheet solvency tests, we see no reason to retain a profits-based test as well, especially if "profits" is to be limited to "revenue profits." *Recommendation*: Amend to conform to Sections 74 and 90.

*Id*., (5): We see no reason for a statutory notice requirement for redemption of preference shares. If the investors want such a requirement, they can insist on its inclusion in the memorandum or articles. *Recommendation*: Delete.

While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 100: We are not familiar with this type of provision and would welcome the opportunity to learn more about it.

Section 113: While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 116: We are not aware of any definition of "debenture" in the Act and believe that one would be helpful.

Section 135(1): Is this provision relating to the manner or transfer of securities exclusive?

Section 140A(3)-(9): We question the need for mandatory disclosure of beneficial interest holders, although we recognize this may largely be a matter of legislative policy. Even if such disclosure is required, we question whether criminal penalties (including in this case up to two years in jail) are appropriate for this type of provision.

Sections 141(1) and 143(1): It is not apparent to us what Section 143(1) adds to Section 141(1).

Section 145: We note that there is no definition of "prospectus" in the Act and believe that one would be helpful. We do not mean to suggest that a statutory definition will solve all problems. The issue of what constitutes a prospectus under the federal securities laws in the U.S. has been an issue frequently litigated even though our federal securities laws do contain a precise definition. *See, e.g., Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). (Section 2(a)(10) of the U.S. Securities Act of 1933, as amended, contains a very broad definition of the word "prospectus".) For South Africa, one might consider even a broad definition to provide guidance to companies and investors as to what a "prospectus" is. In any event, changes in communications technology, such as the advent of the Internet, should be considered in drafting a definition. As well, some types of informal communication, including product advertising and routine corporate communications not aimed at selling securities, could be expressly excluded from the definition.

Section 159: We are not familiar with this type of provision in the U.S. and question whether it is unnecessarily limiting.

Section 170(2)(a): If Section 52 is amended, as suggested above, this section should be amended as appropriate.

Section 170(2)(b): There is generally no advance notice requirement in the U.S. for changes in a corporation's registered office, post office address or registered agent.

While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 171: There is generally no requirement in the U.S. for listing this sort of information concerning directors on a corporation's business letterhead, trade catalogs or trade circulars. In the U.S., this information is generally easily obtainable through publicly available sources. In our meetings in South Africa, it was suggested that the names and addresses of directors might be necessary information for a plaintiff desiring to file a lawsuit against a corporation. However, it appears that this information may not, in fact, be necessary. *Recommendation*: Delete.

While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 172(1)-(4): We see no reason to require a certificate to commence business and believe that the processing of this certificate for every new company probably adds to the workload of SACRO without any benefit to the public. In the U.S., a corporation is generally entitled to conduct business in corporate form after the articles of incorporation have been accepted by the state. *Recommendation*: Delete the requirement for a certificate to commence business.

Sections 179(3), (4), 182 and 83: In addition to questions of practicability, we do not believe that the Registrar should be involved in calling meetings of shareholders and that a court should have this power only on application of the board or shareholders for good cause. Neither the SEC nor the secretaries of state in the U.S. have any such powers.

Section 179(7): *Recommendation*: Amend to permit shareholders of a private company to opt out of holding an annual general meeting because there is no public interest in not permitting private-ordering on this issue.

Sections 180 and 181: We are not clear on the difference between the power of members to convene a general meeting under Section 180 and their power to require the directors to call a general meeting under Section 181.

Section 185: This section, relating to the right of members to require the company to circulate shareholder statements of up to 1,000 words with respect to any proposed resolution or business to be dealt with at an annual general meeting, is analogous to Rule 14a-8 adopted by the SEC pursuant to Section 14(a) of the U.S. Securities Exchange Act of 1934, as amended. Rule 14a-8 provides for several exceptions to a company's obligation to include a proposal in the company's proxy statement. These exclusions include impropriety under state law, violation of law, personal grievance, irrelevance, absence of corporate power or authority to implement the proposal and proposals relating to the ordinary business operations of corporations, which are left to the judgment of the board of directors under corporate statutes in the U.S. *Recommendation*: Consider adding, or authorizing SACRO to provide, similar exceptions.

Section 189(7): While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for violations of the requirements relating to the form of a proxy.

Section 195: In the U.S., the general statutory rule is one vote for each share of stock held, unless otherwise provided in the charter. *See* Model Act § 7.21(a); Delaware General Corporation Law § 212(a). We believe that this default rule is simple but permits a corporation to custom-tailor voting rights to its shareholders' wishes. We are not sure that we understand the purpose or operation of subsection (4)(b). *Recommendation*: Consider amending to provide for one share/one vote subject to alteration in the memorandum or articles.

Sections 198 through 204: These provisions generally seem to us overly detailed for a statute. We suggest that the matters addressed in these provisions could be left to the articles or to practice.

Section 199: While we recognize that the 75% requirement for a special resolution is to a large extent a matter of legislative policy, we wonder whether it is higher than necessary. Moreover, it appears to be an absolute requirement not subject to alteration. *Recommendation*: Amend to permit alteration in the memorandum or articles.

## CHAPTER VIII
## DIRECTORS

It is important for foreign investors to understand the "rules" which govern the behavior of directors in South African corporations and the remedies which are available for violations of the "rules." The regulation of director conduct is a very difficult and multi-faceted question. In the U.S., the question often involves such topics as the standard of care, the duty of care, the business judgment rule, the duty of loyalty, the duty of good faith, and a duty to disclose all material facts. In addition, there are well recognized methods for shareholders to hold directors accountable for violations of their duties (*i.e.*, derivative and class actions). In many states, such as Delaware, these questions are generally resolved and developed through case law. However, more than half of the states in the U.S. have enacted statutory standards of conduct (*see* Model Act § 8.30), and several have enacted or considered enacting business judgment rules. We believe that all states recognize class and derivative actions, although in many states there is little case law in this area and thus the parameters of these actions have not been fully developed.

We note that in South Africa there is neither a statutory scheme nor extensive case law covering the duties and obligations of directors. Likewise, there is little case law on the accountability of directors for violations of duties. In fact, it is difficult to hold directors accountable since the absence of contingent fees and the high costs to unsuccessful litigants discourage shareholders from attempting to hold directors accountable. A method to hold directors accountable for wrongdoing is especially important if company law is largely decriminalized, as we have suggested throughout this Report.

*Recommendation*: Consider regulating director conduct and liability by statute and empowering shareholders to hold directors accountable for violations.

Section 210: In the U.S., stockholders are generally permitted to vote for the election of directors as a slate, without the requirement of a separate election. We see no reason to require a separate vote to be taken for each directorship. *Recommendation*: Delete or amend to permit variation in the memorandum or articles.

Section 211(3): In the U.S., this type of consent requirement is generally limited to publicly held companies. While we recognize that the issue of public notice is to a large extent a matter of legislative policy, we believe that the additional workload for SACRO in lodging these consents may outweigh any public benefit. *Recommendation*: Delete or limit to public companies. In any event, while we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 216(2): While we recognize that public notice is to a large extent a matter of legislative policy, we believe that the additional workload for SACRO in lodging these returns may outweigh any public benefit. While we recognize that penalties are largely a matter of legislative policy, we do not believe that criminal penalties are appropriate for this type of provision.

Section 221(1): The word "of" in the second line apparently should be "or". In the U.S., the general statutory rule is that the board of directors may authorize the issuance of shares of stock, within the limits of the amount of stock authorized by the charter, without the separate approval of shareholders. *See* Model Act § 6.21(b)(in the process of revision); Delaware General Corporation Law § 151(a). In South Africa, we suspect that the practice may be to satisfy Section 221(1) routinely with a boilerplate resolution presented to the shareholders each year approving share issuances for the coming year. We believe that a requirement that is so routinely and generally satisfied does not provide, if it ever did, any material benefit or protection to shareholders. *Recommendation*: Delete this requirement or provide that the memorandum or articles may permit the board of directors to authorize the issuance of shares.

Section 226: The restrictions on financial assistance to directors and officers were generally eliminated in the U.S. many years ago. In many cases, financial assistance to directors and officers may be beneficial to the corporation in securing the employment of qualified individuals to serve in these capacities. In any event, in granting financial assistance to a director or officer, the members of the board would be subject to their legal duties and a director would be ill advised to vote for financial assistance to himself/herself. *Recommendation*: Delete this provision.

Section 246: We suggest that this provision is unnecessary and we wonder whether it prohibits board meetings by telephone, which are generally permitted in the U.S. Model Act § 8.20(b); Delaware General Corporation § 141(i).

Section 247(1): This section prohibits any provision contained in the articles or a contract that purports to exempt any director or officer from liability for negligence, default, breach of duty or breach of trust. We note, however, that Section 248 permits court-ordered relief from liability for "negligence, default, breach of duty or breach of trust," if the director or officer "voted honestly and reasonably." In the mid-1980s, as a result of the severely constricted market for directors and officers liability insurance and a decision of the Supreme Court of Delaware in *Smith v. Van Gorkom*, 488 A.2d 858 (1985), holding directors of a corporation personally liable for money damages for failure to comply with their duty of care, many directors of U.S. corporations resigned or refused to stand for reelection. As a result, most of the U.S. states adopted statutes authorizing the charter to include a provision exculpating directors (and in some cases officers) from liability for money damages. *See* Model Act § 2.02(b)(4); Delaware General Corporation Law § 102(b)(7). Typically, these statutes, which may have had their origin in *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch. 425, apply only to suits by the corporation – directly or derivatively – and suits by stockholders, not to suits by creditors, employees or other third parties; only to suits for money damages, not for equitable relief; and only to suits under state law, not the federal securities or other federal laws. Moreover, these statutes do not permit exculpation for certain egregious misconduct, *e.g.*, bad faith or willful misconduct.

Today, the overwhelming majority of publicly held corporations in the U.S. have director exculpation provisions in their charters. Because these provisions must be included in the charter, stockholder approval is required for existing corporations. In our experience, these provisions have worked well to encourage well qualified individuals to serve on boards and to provide valuable protection to directors in the exercise of their duties. We believe that stockholders should be able to decide for themselves – by inclusion of a provision in the charter – whether to forego a claim against directors for failure to perform their duties so long as that exculpation does not extend to egregious misconduct.

*Recommendation*: Consider adopting a statute permitting the memorandum or articles to include a provision exculpating the directors from liability for money damages in suits by the company – directly or indirectly – or by the shareholders, subject to exceptions for egregious misconduct, *e.g.*, receipt of an improper personal benefit, active and deliberate dishonesty or commission of a crime.

Section 247(2): This provision apparently limits indemnification of directors and officers to liability (*i.e.*, expenses) incurred in successfully defending, to final judgment, suits brought against them. Thus, neither settlements nor expenses incurred in defending a proceeding that ends in a settlement, may be indemnified. We do not believe there is a reasonable basis for this difference in treatment. Broad indemnification of directors and officers for loss, liability, damages and expenses has long been permitted in the U.S., even for adverse judgments. *See* Model Act §§ 8.51 *et seq.*; Delaware General Corporation Law § 145. *Recommendation*: Consider adopting a statute permitting broader indemnification of directors and officers against loss, liability, damages and expenses incurred in connection with their service to the company, perhaps subject to the standard – often found in U.S. statutes – that the directors or officers acted in good faith and in the belief that the action was in the best interests of the corporation.

Sections 257-263: In the U.S., there is generally no provision for the members to cause a government investigation. While we recognize that the issue of the power of the government to conduct investigations of private companies is to a large extent a matter of legislative policy, we question whether shareholders should be able to initiate a government investigation.

Sections 268A-268I: These provisions, relating to the duties and powers of the secretary of the company, are far more extensive than any comparable provisions in the U.S. In our experience, the responsibilities of secretary are set forth in the bylaws and generally include ministerial tasks such as sending out notices of meetings and taking and keeping notes of meetings. In Section 268H, we question the need for the name of the secretary to "be stated on every trade catalog, trade circular and business letter bearing the company's name." In Section 268I, we question the need for mandatory notice to the Registrar of a resignation or removal of a secretary. In addition, while we recognize that the issue of penalties is to a large extent a matter of legislative policy, we do not believe that criminal penalties, including jail in the case of a violation of Section 268C, relating to filling of a vacancy in the office of secretary or failure to give notice of a resignation or removal of a secretary, are appropriate for these types of provisions.

## CHAPTER XI
## ACCOUNTING AND DISCLOSURE

We considered, with the representatives of SACRO, how to increase the efficiency in the lodging and availability of periodic reports and disclosure documents under the Companies Act.

For public companies, the primary periodic reports are the annual financial statements, which must be sent to members and to the Registrar at least 21 days in advance of the annual general meeting (Section 302), and the half-yearly interim financial report, which must be sent to members within three months after the end of the first six months of each fiscal year, and lodged with the Registrar within seven days after issuance (Sections 303 and 306) and, in cases where annual financial statements are not issued, provisional annual financial statements (Sections 304 and 306). Private companies are not subject to the interim report requirement.

In addition, all companies are required to lodge reports with the Registrar upon a change of registered office or postal address (Form CM22), adoption of special resolutions covering such matters as variations in rights of shares (Section 102), repurchases of shares (Section 85) and alterations to the memorandum or articles of association (Sections 55, 58 and 62). In certain circumstances, a company must, by the lodgement of a prescribed form, notify the Registrar of the place where the register of members is kept and of any change in that place (Section 110(4); form CM21) and similarly in regard to the register of directors and officers (Section 215(4); form CM21). A form must also be lodged for consent to appointment as an auditor (form CM31), appointment as a secretary of a public company (form CM27A), and resignation or removal of a secretary of a public company from office (form CM27A). Company name changes must also be reported to the Registrar.

In addition to these reports, which are subject to review only for compliance with formal requirements, the Registrar also receives, reviews and thereafter registers prospectuses for public offers of shares for subscription (Section 145), letters of allocation for rights offerings (Section 146A) and application forms for shares (Section 147). The prospectus must conform to the disclosure requirements of Section 148 of the Act.

The processing of all these reports imposes a substantial burden on SACRO. Equally important, because the events giving rise to some of these requirements – for example, the lodgments related to changes in registered office, postal address, auditor, the corporate secretary or directors – are necessarily unknown to the Registrar until a lodgment occurs, it is impossible for the Registrar to know whether a company is in compliance with its obligations. This means, among other things, that the Registrar cannot effectively enforce the requirements and cannot give lenders and other interested parties any assurance that the Registrar's records are current or that the Company is "in good standing."

*Recommendation*: Consider amendments that would require lodging of a single, annual report which would include the names and particulars of directors, current postal and registered addresses and the name and particulars of the auditor. Such a report could be filed with, or seen as part of, the annual financial report. If more frequently updated information is desirable for public companies, current information about directors, auditors and addresses could also be filed with the interim report.

Such a process could eliminate a number of separate reports, could set firm deadlines for updating information at least once a year and would permit the Registrar to readily identify reporting delinquencies. Once SACRO moves to full availability of its filings on electronic media, the use of an annual report to provide current information on directors, addresses and auditor will also make it easier for users to search for and locate information.

In our several meetings with users of SACRO filings – lawyers, lenders and investors active in South Africa – we were told that, because of the large number of lodgments, delays in filing and registration and the lack of any assurance that available information is current, the present system simply is not relied upon for verification of company information.

With respect to the processing of disclosure documents – principally the prospectus – we are impressed with the quality and timeliness of the review conducted by the Registrar's office. There are, however, possible future concerns: First, the present incidence of prospectus filings – ten to 15 per month – is low. As the economy of South Africa grows, and capital formation increases, the volume will doubtless increase. Second, only one Assistant Registrar is now trained and sufficiently conversant with the statutory requirements of Section 148 to conduct an effective review. For companies that are listing securities on the JSE, or already have listed there, the JSE conducts a separate comprehensive review of the prospectus. We question whether separate reviews by SACRO and the JSE are necessary. We understand that, in connection with proposed revisions of the financial services statutes and the Companies Act, consideration is being given to transferring the prospectus review function to the Financial Services Board as part of its oversight of the securities exchanges and banks. We take no position on whether this transfer should occur. However, we do believe that, wherever the function resides, it is likely that more trained personnel will be required in the future. We also recommend that, once registered, a prospectus should be publicly available through the SACRO Web site and that this should be a high priority in the planning for SACRO's program of making information widely available by electronic means.

Several of the South Africans with whom we met expressed concern that South Africa has no statutory basis for any governmental agency or private body to establish, and require financial reporting in connection with, mandatory accounting standards such as generally accepted accounting principles ("GAAP"). South Africa is not alone in this regard; it is our understanding that many countries do not presently have a statutory basis for mandatory accounting principles. However, we believe that this is an important issue in establishing global acceptance, and a reputation for transparency, for financial statements of South African public companies, and we think the concerns we heard are valid. In the U.S., the SEC has such powers pursuant to federal statutes which permit the SEC to specify the form of, and the methods to be followed in preparing, financial statements required to be filed with the SEC. The SEC has delegated the setting of accounting standards to the private sector Financial Accounting Standards Board but retains the power to approve and reverse and/or revise GAAP under these statutory provisions.

We received the impression that those thinking about the issue in South Africa are searching for something similar, although it was not clear to us whether the statutory authority to set generally accepted accounting principles should reside with the Financial Services Board, which is quasi-public, SACRO, which is public, or some other body.

Another approach would be for South Africa to enact a statutory requirement that financial reports of public companies contain financial statements that conform to international accounting standards as they may be promulgated and revised from time to time by the International Accounting Standards Board ("IASB"). However, the IASB's international accounting standards are not yet universally accepted, because they are still being developed and because the IASB is only a few years old and is viewed by some—including the SEC in the United States—as not yet having established sufficiently definite principles or effective enforcement mechanisms. Even if South Africa were, by statute, to prescribe adherence to internationally accepted accounting principles, as promulgated from time to time by the IASB, there would still be the question of who would have the authority to review the application of such principles by South African companies and the power to enforce compliance by a company and among companies on a consistent basis from period to period. This is an important question if transparency of financial reporting is to be assured. Transparency is essential if South Africa expects to attract to capital to its economy.

Section 285(1): We do not understand the reasons for the restrictions on the first (typically short) fiscal year of a company. *Recommendation*: Consider amending to lift, or ease, these restrictions.

Section 296: The liability of non-signing directors for inaccurate financial statements is not clear.

## CHAPTER XII
## COMPROMISE, AMALGAMATION, ARRANGEMENT AND TAKE-OVERS

We understand that, in addition to addressing reorganizations of insolvent companies, the provisions of Chapter XII permit what, in the U.S., is known as a "merger," *i.e.*, the absorption of one company (including all its assets, liabilities, rights and obligations) into another company, but, unlike the U.S., only with court approval. A vote of three-fourths in value of the creditors or three-fourths of the votes exercisable by members is necessary in order to make the compromise or arrangement binding on that group. See Section 311(2). The court may make provision for the transfer of property or liabilities of the transferor company, allotment or appropriation of shares, rights of dissenting members and various other matters. See Section 313(1).

By contrast, in the U.S., a merger of one company into another is specifically authorized by statute upon the approval of the board of directors of each company and, in most cases, by the stockholders, typically by a majority vote. *See* Model Act §§ 11.02, 11.04; Delaware General Corporation Law § 251. No judicial involvement is required. *Recommendation*: Consider adopting a more abbreviated and simplified procedure for combining two companies into one, requiring the approval of boards of directors and stockholders (with certain exceptions to the shareholder approval requirements, *e.g.*, (a) where one company owns 90% or more of the voting power of the other company or (b) where the surviving company is not issuing shares amounting to more than 20% of its equity) but not of a court.

It should be noted that Canada has followed this approach with the "amalgamation" concept, which is contained in Sections 180 to 186 of the Canadian Business Corporation Act ("CBCA"). Canada also has an "arrangement" provision in Section 192 of the CBCA that is similar to the scheme of arrangement in the Companies Act. It may be worth considering following the Canadian model by retaining the present scheme of arrangement provision, while also adopting an amalgamation or merger statute.

We also suggest that any amalgamation or merger provisions permit what in the U.S. are commonly called triangular or three-party mergers. In these transactions, an acquiring company sets up a new subsidiary and the target merges into the subsidiary (*i.e.*, a forward triangular merger) or the subsidiary merges into the target (*i.e.*, a reverse triangular merger). At the conclusion of the forward triangular merger, the acquiring company controls the subsidiary that holds the target's former assets and liabilities, and the former shareholders of the target own their pro rata shares of the agreed merger consideration, which is typically cash or stock of the acquiring company. At the conclusion of a reverse triangular merger, the acquiring company owns all of the shares of the target (which it has received in exchange for its shares in its former subsidiary), which continues to hold its assets and liabilities, and the former shareholders of the target own their pro rata shares of the merger consideration. Many acquisitions of publicly held companies in the U.S. are effectuated as reverse or forward triangular mergers principally because these transactions avoid exposing the acquiring company's assets to liabilities (including unknown liabilities) of the target. Also, in the reverse triangular merger, the target's assets and liabilities are not transferred and the existence of the target is preserved. These types of three-party transactions are also permitted under the Canadian amalgamation provisions.

## CHAPTER XIII
## EXTERNAL COMPANIES

Section 331(2): We question whether there is any significant benefit to requiring an external company to include the names of its directors, their nationality if not South African, and the names of the local manager and the local secretary on every trade catalog, trade circular or business letter bearing the company's name. *Recommendation*: Consider deleting this provision.

## CHAPTER XIV
## WINDING-UP OF COMPANIES

Generally, the process in Chapter XIV for the winding-up of companies is more extended and formalistic than the comparable process in the U.S. *See* Model Act §§ 14.01 *et seq.*; Delaware General Corporation Law §§ 275 *et seq.* In considering how deeply involved a court or governmental agency should be in this process, it should be remembered that, at least in the U.S., only a small percentage of companies whose existence is terminated ever go through a formal dissolution process. Most U.S. corporations whose existence is terminated do so either through merger with another company or through forfeiture of their charter by the state for non-payment of taxes or failure to comply with filing or other requirements. *Recommendation*: Consider abbreviating and simplifying the statutory requirements for winding-up, including eliminating the requirement of court approval.

Section 424(1): The range of persons who may incur liability under this provision and the potentially unlimited personal liability for the company's debts seem to us to be undesirably broad. This is particularly so in view of the fact that liability under Section 424(1) is not limited to instances involving "an intent to defraud" (which, we understand, has been interpreted to require conscious dishonesty) but extends also to "reckless" conduct (which, we understand, has been interpreted as connoting negligence). The limitations on potential liability under this provision are that the person concerned must have been "knowing" (although it is unclear to us precisely what that knowledge must comprise) and that he or she must also have been "a party to the carrying on of business" in the reckless or fraudulent manner. We appreciate that the evidentiary difficulties of proving "an intent to fraud" in this context, in the required sense of conscious dishonesty, was the factor which motivated the extension of this provision to include "reckless" conduct. Nonetheless, we have reservations about the provision in its present form, for the following reasons. It is clear that a director is a "party to" the carrying on of a company's business, and the prospect of personal liability under this provision for actions taken or advice given honestly, though negligently, may, we believe, be a significant disincentive to accepting appointment as a director. Moreover, it seems to us that the words "knowingly" and "party to the carrying on of business" may, in some circumstances, extend the net of liability to encompass outside professional advisers to the company, such as auditors and legal counsel. At the least, the broad language of Section 424(1), with its implicit hazard of potential personal liability for corporate debts, may deter professional advisers from acting for the company or from acquiring an in-depth "knowledge" of the affairs of the company that could later constitute an element in their legal liability under this provision.

*Recommendations*: Consider limiting the classes of persons to which Section 424(l) applies; consider more clearly specifying the degree of knowledge required to establish liability; and consider whether liability should be proportionate to fault rather than unlimited, joint and several. Consider a broader statute prohibiting intentional or reckless fraudulent or manipulative behavior in connection with the purchase or sale of securities. In this regard, consider creating a private right of action by shareholders and other market participants who have been injured by fraudulent or manipulative behavior. This might correspond roughly to Section 10(b) and Rule 10b-5 under the U.S. Securities Exchange Act of 1934, as amended, and the case law that permits private class actions under those provisions.

## CHAPTER XV A
## REGULATION OF SECURITIES

Chapter XV A of the Companies Act provides for the regulation of change-of-control transactions. This part of the statute appears to be based on the model of the Takeover Panel, which has operated in the United Kingdom for over 25 years. We met with members of the South African Securities Regulation Panel, which administers Chapter XV A, and have the impression that the Panel is developing the experience, and is in the process of acquiring the resources, that will allow it to act effectively to protect the interests of minority shareholders and other constituencies affected by control changes. While the U.K. model followed in Chapter XV A is quite different from the approach in the U. S. – which has more detailed and objective rules relating to tender offer terms and disclosures – we believe that the approach of Chapter XV A may well be appropriate for South Africa. The relatively informal procedures of the Panel, and its ability to consider a wide range of issues not limited to the specific terms of an offer, may be appropriate for a business community, such as South Africa's, which currently has a relatively small number of public companies and a small number of change-of-control transactions, but has a significant concentration of companies' ownership. As the South African economy grows and the number of change-of-control transactions increases, regulations that are more detailed and more objectively defined, with less discretion in the Panel, may become appropriate, so that parties considering a transaction can more accurately predict the likely regulatory response. In any event, improving disclosure and transparency is fundamental to the continued development of a capital-attracting economy. The market for company control, together with the right of investors to select the board, can be a healthy check on management.

# PART III

# RECOMMENDATIONS WITH RESPECT TO THE CLOSE CORPORATIONS ACT

## PART III: RECOMMENDATIONS WITH RESPECT TO THE CLOSE CORPORATIONS ACT

In general, what the Close Corporations Act identifies as a close corporation is closest to what states in the U.S. identify as a limited liability company (an "LLC"). While all U.S. states now have statutes authorizing LLCs, many also have adopted statutes permitting the formation of corporations owned and controlled by a small number of shareholders, all agreeing to be governed as a close corporation. States vary in their approach to U.S. close corporations. Some, like Delaware and Maryland, have enacted separate close corporation statutes, while others, like Ohio, address close corporations within the statute pertaining to corporations generally. Regardless of the manner used to elect status as a U.S. close corporation, the primary purpose of the governing statute is to alleviate many, but not all, corporate administrative tasks and limitations that a regular corporation must observe in order to shield its shareholders from personal liability. Additional flexibility is permitted by the federal taxing authorities permitting shareholders of smaller corporations, many of which are U.S. close corporations, to elect to have the corporation disregarded for most income tax purposes, resulting in a single level of taxation for the shareholders. While the LLC also offers such tax advantages as well a form of governance created by agreement among members, the corporation continues to be the preferred business vehicle throughout the U.S. Consequently, U.S. close corporations continue to play a significant role in the formation of new business ventures.

In South Africa, we understand that a primary and commendable objective of the Close Corporations Act is to authorize the creation of a new form of business entity which offers the benefits of separate legal personality (and, therefore, non-liability of its equity holders) and is more readily accessible to the public. An additional objective appears to be to aid in the formation of small business ventures among individuals not yet possessing the levels of sophistication or capital to form public or private companies. In particular, the Close Corporations Act seeks to significantly reduce (i) the amount of paperwork required to be filed with the Registrar and (ii) certain accounting requirements otherwise imposed upon public and private companies. As a result, the number of close corporations formed annually far exceeds the number of other types of corporate entities, with the aggregate current number of close corporations existing on the books of the Registrar exceeding 600,000.

Notwithstanding this apparent popularity of the close corporation among business people, we found that a number of provisions within the Close Corporations Act might be changed to better facilitate the incorporation process. Some of our comments reflect the same basic observations and suggestions we have made regarding public and private companies under the Companies Act. Others, however, are specific to the Close Corporations Act. In light of the preliminary nature of our evaluation and this report, the following comments are summary in nature. In addition, our comments are presented in no particular ranking or order, as we believe each to be significant:

- While the Close Corporations Act reduces the founding statement to a single page and eliminates the requirement of articles of association, there are still a number of other steps required to be taken by the business owners in order to bring the close corporation into legal existence. For instance, in addition to the founding statement, members must also file papers indicating the selection of a registered agent as well as an accounting officer. In all, we counted approximately eight documents that are required to be filed by the member(s) in order to complete the close corporation incorporation process. The costs of these requirements may make a close corporation unattractive to micro-businesses, including start-up businesses.

In the U.S., there is little difference in the process used to form regular or close corporations because the process of incorporation has been greatly simplified. In some states such as Delaware, the process has been reduced to the electronic filing of a single-page form containing both the articles of incorporation (the primary corporate governance instrument) and the information regarding the name and identity of the company's statutory agent for service of legal process. Delaware can process these forms and complete the incorporation process in as little as two hours. In no state is it required that (a) the incorporators also be the members of the entity or (b) the company have retained the services of an accountant.

The net effect of the U.S. business entity formation process is that a U.S. close corporation or an LLC can be established by most individuals without the participation of legal or accounting professionals. As a result, the overall cost and time required to complete the incorporation process has been significantly reduced, permitting the small business owner to redirect capital to other aspects of the business.

- In South Africa, the number of members in a close corporation is limited to ten. In addition, no two persons can share ownership of a membership unit. As a result, if a husband and wife are members of the corporation, they are counted as two members rather than having the option of holding one membership unit jointly and severally, with right of survivorship. We were unable to ascertain the significance of limiting the size of close corporations to ten members or the reasons for imposing the anti-joint ownership rules.

  Under U.S. tax laws, until recently, the number of permitted shareholders of Subchapter S corporations was limited to 35. Subchapter S status, which allows a closely held corporate entity to be disregarded for federal and state income tax purposes, has been hugely popular and has played an important role in capital formation in the U.S. by aiding small business ventures in the early years. Recently, the Internal Revenue Service increased the number of permitted shareholders to 75 in an effort to encourage existing sub-S corporations to continue to raise capital for growth and to accommodate more sophisticated and capital-intensive start-up businesses.

  We recommend a reexamination of both the limit on the number of members currently imposed on close corporations as well as the anti-joint ownership rules. Such a review should take into account the needs of start-up businesses as well as the life cycle of developing businesses, weighing these needs against others such as tax and cost implications. If the only choice of a close corporation with ten members seeking to add an additional member (and thereby additional capital for the business) is to become either a private company or a public company (and incur, as a result, the regulatory framework and costs of those entities), there would appear to be a significant disincentive to add the eleventh member. Likewise, permitting joint ownership of membership interests and counting the same as a single member will also, most likely, assist in the formation of family-owned businesses without the expense of sacrificing a membership spot.

- Under the Close Corporations Act, membership in close corporations is limited to natural persons and two or more persons cannot be joint holders of a single membership interest. In addition, in order for the close corporation to qualify for a concessional tax rate on the first R100,000 of taxable income, its members may not hold membership interests in more than one corporation.

  In most U.S. states, there are no such restrictions with respect to close corporations or limited liability companies and no such fiscal disadvantages to the close corporation where a member has an interest in more than one such entity. In particular, corporations and limited liability companies are often formed to serve as the shareholder or member of close corporations and LLCs, respectively. As a result, even small business owners and investors in the U.S. are permitted great flexibility in structuring business entities in the way best suiting their particular needs and the needs of their investors.

- The Close Corporations Act provides that members are not generally liable for the debts of the corporation except under very specific circumstances. However, the scope and breadth of some of those exceptions may too easily expose unsophisticated investors to personal liability. For instance, Section 63(h) provides that if the corporation fails to have in place a statutory accounting officer, any member who knew of such vacancy is personally liable for all of the debts of the corporation. We believe that such openings for personal exposure may discourage business owners from using a close corporation, forcing instead a choice between operating as a private or public company. Furthermore, we believe that such provisions potentially send a message that is inconsistent with the public policy objective of encouraging small business formation and entrepreneurial activity.

- The Close Corporations Act requires that an interest in the corporation must be stated in percentage. Members should be afforded the right to select the manner in which the interest will be represented. Expressing the interests in units or shares often makes it easier for inexperienced investors in small business to add new investors or resolve ownership issues among existing owners.

- Payment of the membership interest may be made within 90 days of issuance of the interests with payment in the form of cash or property. A member may not pay for his membership interest with a promissory note. There is no such blanket restriction under U.S. laws. The popular standard in the U.S. today is to allow a shareholder or member in a close corporation to arrange whatever payment terms are acceptable between the shareholder/member and the corporation. Thus, a shareholder/member may deliver a promissory note representing his consideration for payment of the shares/membership interest and upon receipt of the note, the shares/membership interest is considered to be fully paid and non-assessable. Moreover, capital formation requires that the parties be able to be as creative as the situation requires in structuring their transaction and the capitalization of the enterprise.

- Significant penalties are imposed upon members who fail to comply with the technical requirements of the Close Corporations Act. There are a number of violations of the Close Corporations Act that would give rise to considerable penalties and/or expose the members to the possibility of imprisonment. These potential penalties may be ill advised since, at least in some cases, they will be borne by unsophisticated business people who may fail to meet technical requirements of the Close Corporations Act through inadvertence or inexperience rather than through willfulness or malice. The result may be to raise the stakes of incorporating a venture. While U.S. state corporation codes do impose monetary penalties in rare instances, there are few, if any, criminal sanctions.

- The Close Corporations Act permits actions in writing if signed by all the members. The modern trend in the U.S. is to permit the requisite number of members to take the action in writing, even if they constitute less than all members, provided that a copy of the action is delivered to the other shareholders prior to or within a reasonable time following the earlier of the date the action was taken or the effective date of the action.

- The list of the accounting and financial records required pursuant to Section 56 to be maintained by the corporation almost ensures that a small businessperson will not be able to operate and maintain the corporation without professional assistance. The annual financial disclosures required to be made pursuant to Section 58 should be sufficient to protect the interests of members. The imposition of Section 57 standards results in a higher cost to form and operate a close corporation and, as a result, may serve as a barrier to use of this type of entity by small business owners.

With these observations in mind, we offer the following recommendations as to the Close Corporations Act, grouped under the same headings as used in the Companies Act. As with the Companies Act, we have tried to limit our recommendations to what we consider the most important substantive issues and we also pose various questions and comments based on our experience. (Part numbers follow the part numbers in the Close Corporations Act.)

## Part I
## Formation and Juristic Personality of Close Corporations

Section 2(1): What is the purpose of limiting the number of members of a close corporation? See comments on Part IV, Section 28.

## Part II
## Administration of Act

Section 3: *Recommendation*: This Section and Chapter II, Section 5 of the Close Corporations Act contemplate a single office in which corporation filings are lodged. Consideration should be given to revising this section (and its coordinating provisions in the Act) to provide for the electronic lodgement of close corporation filings at locations other than the official Registrar's office located in Pretoria. Several states in the U.S., including Delaware, are using or are considering the use of deputy registrars or local offices to make it easier, and to further reduce the cost and time required, to bring a corporation into existence.

## Part III
## Registration, Deregistration and Conversion

Section 12: *Recommendation:* Simplify the founding statement. For example, consistent with our recommendations with respect to general corporations, only one person should be required to sign the founding statement. As presently drafted, each member or his representative is required to sign.

Section 12(b): The Close Corporations Act contemplates that a close corporation is to be restricted to the business stated in its founding statement. The modern trend in the U.S. recognizes that business ventures need flexibility to quickly respond to market opportunities. Accordingly, the legal doctrine of *ultra vires* has been sharply reduced and corporations are permitted to provide in their charters that the corporation may engage in any business permitted by law. *Recommendation:* Amend Section 12(b) to provide that a close corporation need not be restricted to any specific business. This change will eliminate the need for a close corporation to file an amendment to the founding statement, pursuant to Section 15, each time it takes on a new business opportunity that is outside the founding statement.

Section 12(c): Many corporations do not require a physical location or assets in order to conduct business and South African company law should recognize and encourage this market reality. *Recommendation*: Consider eliminating Section 12(c) in its entirety and requiring only that the corporation have a registered agent upon whom service can be made or, conversely, amending the Section to recognize that a close corporation may only have a mailing address (which might be only a post office address or an internet address). This change would eliminate the need to file an amendment to the founding statement pursuant to Section 15.

Section 12(d): There is no comparable provision in laws governing corporations in the United States. The identity of owners of privately owned business enterprises (with the possible exception of limited partnerships owning real property) is largely regarded as a private affair. Shareholders may, under certain circumstances, obtain from the corporation the identity of other shareholders. However, this is regarded as a matter between the corporation and the requesting shareholder. The state government is not involved because it does not have the information being requested. *Recommendation*: Consider eliminating Section 12(d) in its entirety. This change would eliminate the need to file an amendment to the founding statement each time an investor is added or deleted, as currently required under Section 15.

Section 12(e): *Recommendation*: Shareholders should be provided the option to express their membership interest in percentages or in other forms approved by the shareholders. Permitting close corporations the option, for instance, of using shares may simplify the transfer of ownership as well as equity investing as it is generally easier to understand and administer than percentage ownerships.

Section 13: *Recommendation*: Consider eliminating the requirement for filing the founding statement in triplicate as it seems unduly burdensome with little compensating benefit.

Section 15: *Recommendation*: Consider eliminating the requirement for a close corporation to file an amendment to the founding statement each time there is a change in the ownership percentages of the corporation.

Section 16: *Recommendation*: Consider eliminating this Section if the Registrar is successful in converting to an electronic filing system and in converting all filings to PDF or other electronic format. In such event, any person should be able to obtain access to a copy of the founding statement through an electronic inquiry to the Registrar, thereby obviating the need for the close corporation to maintain a copy. Consistent with our general comments regarding decriminalization of the Companies Act, Section 16(3) may be eliminated.

Section 19: Same comments as referred to in Part II regarding the reservation of names. As drafted, Section 19 requires the Registrar to delay accepting the founding statement for filing until after the Registrar has reviewed and approved the selected name. *Recommendation*: A close corporation should be legally formed upon the submission of the founding statement and the requisite filing fee, as contemplated under Section 13. Section 20 is sufficient to provide for a change of name if required, although one year may be too long a period of time as a corporation may have invested significant amounts by then in promoting its corporate name. By making this change, one source of backlog (delaying filings while names are checked) in the Registrar's office can be removed or significantly lessened.

Section 24: Pursuant to Section 24(1), a close corporation may accept as consideration for its membership interests only money or property. Section 6.21(b) of the Model Act takes the position that a promissory note of the investor is valid consideration. Section 24(4) is already moving in this direction by permitting an investor a 90-day period following his subscription to actually pay the money for his interest in the close corporation. *Recommendation:* Broaden Section 24(1) to permit a close corporation and its members to privately agree upon the form and timing of the consideration to be paid to and received by the corporation in exchange for its membership interests.

## Part IV
## Membership

Section 28: Is there a reason to limit the close corporation to ten members? In the U.S., corporations electing pass-through status (the so-called Subchapter S corporations) were, until recently, limited to 35 shareholders. That number has been increased to 75 to reflect the growth and complexity of small business enterprises that still need favorable tax treatment. *Recommendation*: Consider increasing the number of members permitted to maintain the entity as a close corporation.

Section 29: This Section restricts members to natural persons, thereby resulting in potential personal liability of members. Moreover, in the U.S., the venture capital community has proven to be a rich source of funding for new highly speculative ventures. Venture funds are generally organized as limited liability companies, limited partnerships or specialized trusts. Section 29 currently precludes any of these types of vehicles from investing in a South African close corporation. *Recommendation*: Consider reducing the restrictions on the requirements for membership of a close corporation.

## Part V
## Internal Relations

Section 42: This Section appears to have the potential for deterring a small business owner from choosing the close corporation form. Although some U.S. courts have held that a fiduciary duty is owed among shareholders in closely held corporations on a par with that which is owed by one partner to another, the application of this rule has almost always been reserved for abuses by a majority shareholder of minority shareholders. Nowhere has the rule been extended, or codified, in the manner provided in Section 42. *Recommendation*: Consider either eliminating this provision in its entirety or significantly carving back the scope of liability assumed merely by being a member in a close corporation.

Section 43: *Recommendation*: Same comment as Section 42.

Section 48(1)(c): *Recommendation*: Consider deleting this subsection in its entirety. Under Section 7.22 of the Model Act, shareholders are permitted to give their proxies to vote at meetings of shareholders.

Section 48(3)(b): *Recommendatio*n: Consider amending this Section to provide that an action in writing signed by the required number of shareholders to effect such action is effective in lieu of a meeting. Such a change would be consistent both with the Model Act as well as the growing trend within the U.S.

Section 52(1): This Section prohibits a corporation from making a loan to any of its members or to another corporation that is more than 50%-controlled by a member or members. We do not understand the background or intent of this restriction. However, we suggest that such a restriction may serve as an impediment to capital formation and the ability of corporations to employ equity structures consistent with the demands of the market.

## Part VII
## Accounting and Disclosure

Section 56: *Recommendation*: Consider deleting this Section in its entirety. There is generally no analog for this requirement in U.S. laws generally governing non-public corporations. The Model Act and relevant state laws generally provide that the corporation must make available to its shareholders certain books and records of the corporation for any proper purpose. There is no specific list of what records the corporation is required to keep. The elimination of Section 56 may also reduce or eliminate the need for the appointment of an accounting officer under Section 59.

The Model Act and most state laws also provide that the corporation must provide its shareholders with certain basic financial information (in the form of a balance sheet and income statement) each year at the time of the annual meeting of shareholders. This requirement is very much the same as reflected in Section 58. These disclosures should be sufficient to protect a shareholder's interest without unduly burdening the corporation in keeping records that may not be useful or relevant to the corporation's actual operations.

Section 59 and 60: As discussed in the Summary and in our discussion regarding regular corporations, we question the usefulness of requiring the corporation to appoint an accounting officer. Although the qualifications of an accounting officer are somewhat less than the qualifications required of their counterparts in non-close corporations, the level of qualification still almost assures that the close corporation will have to employ an external agent to fulfill this role. Consequently, a close corporation cannot be formed solely by the layperson and the cost of operating a close corporation is significantly increased.

## Part X
## Penalties and General

Section 82: *Recommendation*: Consider eliminating criminal penalties for failure to comply with the provisions of the Close Corporations Act.

# PART IV

# CONCLUSIONS

## PART IV: CONCLUSIONS

1. We are aware that company law, while important and indispensable, is by no means the most significant element of a productive economy. The overriding issue for any market-based economy is vibrant capital formation and deployment. It has aptly been said that company law is to business as the shell is to the oyster: It is what goes on inside that counts most. Good company law can create a protective and fertile environment for economic activity but it cannot, by itself, create that activity. Only entrepreneurial citizens can do that, and they respond to a wide range of incentives and disincentives, only one of which is a clear, predictable and enforceable governing law.

2. It is not our charge to offer advice or recommendations with respect to issues of capital formation and economic growth beyond the operations of SACRO and the statutes it administers. We have noted, however, during our visit, the importance of small businesses in South Africa. Even in the U.S., well over half of all jobs are created by small businesses. It is axiomatic that growing small businesses will create even more jobs. To encourage small businesses, South Africa may want to consider financial incentives, including grants, loans or loan guarantees, to small and medium-sized enterprises ("SMEs").

South Africa may also want to consider legislation similar to the U.S. Community Reinvestment Act to compel banks to make loans to SMEs or to intermediaries such as community banks and co-operatives. During our visit, we were informed that banks in South Africa have concerns about such legislation because of the high loss rate on prior voluntary efforts at community-based small business lending. We believe, however, that there are many ways to improve community-based small business lending that have worked in other countries and are worthy of consideration for South Africa. For example, currently in South Africa there are co-operatives and credit unions for farmers, but not for township dwellers. South Africa may also want to consider creating an agency similar to the U.S. Small Business Administration, which can provide financing and other assistance to start-ups and other SMEs and also encourage the creation of local, grass-roots cooperative and entrepreneurial organizations and lending institutions.

3. During our visit in South Africa, we established a broad network of relationships with many interested people in the company law field, including SACRO, the Standing Advisory Committee on Company Law and leading company law practitioners and teachers. We intend to maintain a continuing relationship with all of these people. Since returning to the U.S., Team members have been in contact by e-mail with a number of those with whom we met in South Africa. Several of the South African lawyers we met, and the Institute of Directors, have been added to the listserv of the ABA's Committee on Corporate Governance, chaired by Team member John Olson. Team members have also submitted comments and suggestions on the draft second edition of the King Committee Report on corporate governance in South Africa. The Team has designated our Chair, Jim Hanks, to serve as a continuing liaison for communication between the Team and various interested parties in South Africa, but all of the members of the Team have expressed their readiness to make themselves available for further participation. The Team can make a further visit to South Africa if this is desirable.

4. We have recommended to USAID that financing be provided so that key people at SACRO can come to the U.S. to see firsthand the operations of – and to meet with key officials at -- the SEC, the Secretary of State's office in Delaware (and perhaps similar agencies in other states) and the New York Stock Exchange.

5. We wish to record our admiration for the work being done in South Africa by USAID. As we became aware of the breadth, depth and influence of USAID's work in South Africa and elsewhere in the region, we were not only impressed but awed. We hope that our Government will continue to provide funding to USAID for its important work in sub-Saharan Africa.

R. Franklin Balotti
James J. Hanks, Jr. (Chair)
John F. Olson
Samuel C. Thompson, Jr.
Craig Owen White

December, 2001

# APPENDIX A

## BIOGRAPHIES OF TEAM MEMBERS

## APPENDIX A: BIOGRAPHIES OF TEAM MEMBERS

**R. FRANKLIN BALOTTI** is a member of the Wilmington, Delaware law firm of Richards, Layton & Finger, P.A. He earned his B.A. from Hamilton College in 1964 and his LL.B. from Cornell University School of Law in 1967. Mr. Balotti is a member of the American Bar Association Sections of Business Law (and formerly a member of its Council), Litigation and International Law & Practice, the ABA Standing Committee on Federal Judicial Improvements, the Delaware State Bar Association's Professional Guidance Committee, the liaison between the Judicial Nominating Commission and the Delaware State Bar Association's Committee on Judicial Appointments, the Colorado Bar Association, the Cornell Law School Advisory Council, and The American Law Institute; a Fellow of American College of Trial Lawyers; and a Fellow of the American Bar Foundation. Mr. Balotti has served as Chair of the Committee on Business and Corporate Litigation and Co-chair of the Committee on Business Courts of the Business Law Section of the American Bar Association and President, President-Elect, Vice President, Secretary and Member of the Executive Committee of the Delaware State Bar Association. He has served as Chair of the Delaware State Board of Bar Examiners and Chair of the Board on the Unauthorized Practice of Law of the Supreme Court of Delaware. Mr. Balotti was an Adjunct Professor at the Widener University School of Law during 1991-1993 and 1995, the Distinguished Practitioner-in-Residence at Cornell Law School in the Fall of 1996, and the Visiting Distinguished Corporate Professor, University of Miami School of Law for the Spring 1998 semester. He currently is an Adjunct Professor at the Cornell Law School and the University of Miami School of Law. Mr. Balotti has co-authored/co-edited numerous publications, including *The Delaware Law of Corporations and Business Organizations* (3d ed. 1998) and *Meetings of Stockholders* (3d ed. 1998).

**JAMES J. HANKS, JR.** is a partner in the Baltimore office of the 425-lawyer firm of Ballard Spahr Andrews & Ingersoll, LLP, an Adjunct Professor of Law at Cornell Law School and an Adjunct Professor of Management at Cornell Business School. He received his A.B. degree from Princeton University, his LL.B. from the University of Maryland Law School, where he was an editor of the *Maryland Law Review*, and his LL.M. from Harvard University. During the 1967-68 term, Mr. Hanks served as law clerk to Judge Charles Fahy of the United States Court of Appeals for the District of Columbia Circuit. In private practice, he represents publicly and privately held corporations and other entities in securities offerings and other financing transactions. He has represented buyers or sellers in over 250 mergers or acquisitions, including several valued at over ten billion dollars. Mr. Hanks has testified in both federal and state courts as an expert witness on corporation and securities law matters. He frequently serves as independent counsel to boards of directors and board committees in connection with major transactions, stockholder litigation and conflicts of interest. In 1997 and 2000, Mr. Hanks was an Adjunct Professor of Law at Northwestern Law School. Since 1996, Mr. Hanks has also taught a course in U.S. and European corporate governance at the Cornell Law School-Université de Paris I (Sorbonne) Summer Institute in Paris. Mr. Hanks is the author of *Maryland Corporation Law* (Aspen Law & Business Supp. 2001) and the co-author (with Bayless Manning) of the third edition of *Legal Capital*. He is also the author of many law review articles and a frequent speaker on corporation law issues. He has been actively involved in drafting and testifying on behalf of revisions to the Maryland General Corporation Law, the Maryland Real

Estate Investment Trust Law and the Model Business Corporation Act and is a member of The American Law Institute.

**JOHN F. OLSON** is a senior partner in Gibson, Dunn & Crutcher's Washington, D.C. office. He has extensive experience in general representation of business organizations as to corporate securities, corporate finance and merger and acquisition matters. He has acted as special counsel for boards of directors and board committees on corporate governance issues and in assessing shareholder litigation, responding to business combination proposals and conducting internal investigations. He also has represented corporations, broker-dealer firms and individuals in defense of Securities and Exchange Commission and other governmental investigations. Mr. Olson served as Chairman of the American Bar Association's (ABA) Committee on Federal Regulation of Securities (1991-1995) and is a member of the Executive Council of the Securities Committee of the Federal Bar Association. He currently serves as a member of the Council of the ABA's Business Law Section and of the Committee on Corporate Laws. He serves on the Legal Advisory Committee of the New York Stock Exchange and has served as a member of the Legal Advisory Board of the National Association of Securities Dealers. He was a Founding Trustee of the American College of Investment Counsel, and served on a select committee of leading securities lawyers, appointed by the chairman of the Securities Subcommittee of the Senate Banking Committee, which drafted definitive insider trading legislation introduced in the United States Congress by Senators Riegle and D'Amato. From 1983 to 1985, Mr. Olson served as General Counsel of The District of Columbia Bar. He chaired the Task Force on Regulation of Insider Trading of the ABA, which produced a comprehensive analysis of and report on U.S. insider trading law. He served on the ABA Coordinating Group on Regulatory Reform, which coordinated the work of all ABA sections and committees on regulatory reform issues in Congress and served for three years as Chairman of the ABA's Committee on Foreign Claims. Mr. Olson is a member of the American Law Institute. He recently served on the Blue Ribbon Commission on CEO Succession of the National Association of Corporate Directors and on the NACD's Blue Ribbon Commission on Audit Committees. A frequent lecturer at legal and business seminars, he has co-chaired the annual program, "Proxy Statements, Annual Meetings and Disclosure Documents" for 23 years, serves on the advisory committees for the San Diego Securities Regulation Institute and the Practicing Law Institute's Annual Securities Regulation Institute, and is the author of more than 100 articles on legal subjects. He co-chairs the American Law Institute/American Bar Association annual Post-Graduate Course in Federal Securities Law. Mr. Olson is a member of the Editorial Advisory Boards of *Insights: The Corporate and Securities Law Advisor*, the Bureau of National Affairs' *Securities Regulation & Law Report* and the *Corporate Governance Advisor*. He is the co-author, with Josiah Hatch, III, of *Director and Officer Liability: Indemnification and Insurance*, published by Clark Boardman Callaghan Company in 1990 [revised 2001]. Mr. Olson is co-editor in chief of *Securities in the Electronic Age: A Practical Guide*, third edition, published in 2001, and is co-editor of the newsletter, *wallstreetlawyer.com*, which covers legal developments with respect to use of electronic communications in the securities markets.

**SAMUEL C. THOMPSON, JR.** is Professor of Law and Director of the Center for the Study of Mergers and Acquisitions at the University of Miami School of Law. In January 1999, Professor Thompson was appointed by the U.S. Treasury Department as U.S. Tax Policy Advisor to the South African Ministry of Finance where he served until May 2000. During the Fall 1998 semester, he was the Jacquin D. Bierman Visiting Professor of Taxation at the Yale Law School. From 1994 to 1998, he served as Dean of the University of Miami School of Law. He came to the University of Miami from the UCLA School of Law where he was Professor of Law since 1990. He was elected Teacher of the Year by the students at the UCLA School of Law in 1993 and by the students of the University of Miami School of Law in 1995 and 1998. Before joining the UCLA faculty, he was the partner in charge of the Tax Division of the Chicago-based law firm, Schiff, Hardin & Waite, where he practiced for nine years. Prior to joining Schiff, Hardin, Sam was a Professor of Law at the University of Virginia School of Law. Before joining the Virginia faculty, Sam worked in the United States Treasury's Office of Tax Legislative Counsel and International Tax Counsel. Early in his career, Sam worked in the tax department of Davis, Polk & Wardwell, and was an Associate Professor of Tax Law at the Northwestern University School of Law. Sam is affiliated with both the University of Miami School of Law and the University of Virginia School of Law, where he is currently serving as the John A. Ewald Distinguished Visiting Professor. Sam earned his law degree from the University of Pennsylvania in 1971 and his LL.M. in Taxation from New York University in 1973. He is the author of several books, including *Business Planning for Mergers and Acquisitions* (Carolina Academic Press, 1997; second edition, 2001*); A Practitioner's Guide to the Economics of the Antitrust Merger Guidelines* (ALI-ABA, 1997); *U.S. Taxation of International Transactions* (West Publishing, 1995); *Taxation of Business Entities* (West Publishing, 1994); and *Reform of the Taxation of Mergers, Acquisitions, and LBOs* (Carolina Academic Press, 1993). Sam is a member of, *inter alia,* The American Law Institute, the American College of Tax Counsel, and the American Bar Association. He also served on the Advisory Committee on Tax Litigation for the Tax Division of the United States Department of Justice in 1979-80, and on the Advisory Group to the Commissioner of the Internal Revenue Service in 1985-1987.

**CRAIG OWEN WHITE** is a graduate of Williams College (B.A., 1979) and the University of Virginia School of Law (J.D., 1983). Upon graduation from Williams College, Craig lived in Kenya and Ghana as a Thomas J. Watson Foundation Fellow where he conducted an independent study of low income housing conditions in developing nations. Craig is a partner in the law firm of Hahn Loeser & Parks LLP, Cleveland, Ohio, where he is member of the firm's business practice group and co-chairs its sections on E-Business and Government Relations. Craig also chairs the firm's Venture Opportunities practice group dedicated to representing business ventures involving persons of color. Craig's practice is focused on general corporate representation, with an emphasis on representing closely-held business enterprises. Craig serves as the North American group counsel for Head N.V., an international sports equipment manufacturer brands such as Head tennis racquets and skis, Mares and Dacor scuba diving equipment, Tyrolia ski bindings and Penn tennis balls. Craig also represents and serves as a director of Great Lakes Cheese Co., Inc., one of the nation's largest processor and distributor of cheese and cheese products, and Shorebank Cleveland, a community bank focused on economic empowerment. Craig also serves on the firm's board of directors and is active in various community and civic organizations. Craig is also a member of the Corporate Laws Committee of the Section of Business of the American Bar Association.

# APPENDIX B

## INDIVIDUALS WITH WHOM WE MET

## IN SOUTH AFRICA

(Partial List)

## APPENDIX B: INDIVIDUALS WITH WHOM WE MET IN SOUTH AFRICA

**(Partial List)**

Dr. Michael Anderson, Chief of Party/Director, SEGA/MESP Project, Nathan Associates, Inc.

Nambita Bam, Legal Compliance Officer, Southern Africa Enterprise Development Fund

Rob Barrow, Deputy Executive Officer, Investment Institutions, Financial Services Board

Kristen Bauer, Economic Officer, Embassy of the United States, Pretoria

Patrick Birley, Chief Executive Officer, The South African Futures Exchange

John Burke, Director: Listings, Securities Exchange South Africa

Farouk Cassim, Professor of Law, University of the Witwatersrand School of Law

Farhad Chothia, Transactor, Regional Corporate Finance, Citibank, N.A.

Jeffrey Closenberg, Director, Mallinicks

Neal P. Cohen, United States Agency for International Development (U.S. AID)

Richard Connellan, Executive Director, Securities Regulation Panel

Richard Crosby, CA (SA), General Manager Finance, Administration & Statutory, SAFEX, The South African Futures Exchange

Johan C. de la Rey, CA (SA) Law Administration: Legislation, South African Revenue Service

Janse de Villiers, Tour Guide, Kwathland Tours & Safaris

Piet Delport, Professor of Mercantile Law, University of Pretoria School of Law

William Detoit, Project Manager, SACRO

Abel Diamini, Audit, Arthur Andersen & Co.

Adv. H. P. (Flip) Dwinger, Manager, Legal Services, SACRO

Paul M. Fermoile, Economic Officer, Embassy of the United States

Richard Goldstone, Justice, Constitutional Court of South Africa, and Chairman, Standing Advisory Committee on the Companies Act

Luanne Grant, Executive Director, American Chamber of Commerce in South Africa

Cyril Jaffe, Chairman, Securities Regulation Panel

Adv. W. L. (Werner) Johnson, Deputy Registrar, SACRO

J. Michael Judin, Goldman Judin Maisels Inc.

Michael Katz, Chairman, Edward Nathan & Friedland

Robert H. Kelley III, Interim CEO, Southern Africa Enterprise Development Fund

Tom Lawless, Chief Executive Officer, Bond Exchange of South Africa

Corli Le Roux, Senior Supervisor, Legal Division, SAFEX, The South African Futures Exchange

Delano E. Lewis, Ambassador of the United States to South Africa

Russell M. Loubser, Chief Executive Officer, Securities Exchange South Africa

Duncan Macalester

Nompilo Mali, Economist, U.S. AID

Adv. F. D. M. (Felix) Malunga, Registrar, South African Companies Regulatory Office (SACRO)

Silas Modiba, Assistant Registrar, South African Companies Regulatory Office (SACRO)

Nicky Newton-King, Director: New Business & General Counsel, Securities Exchange South Africa

Greg Nott, LeBoeuf, Lamb, Greene & Macrae Pty (Ltd.), Johannesburg

Shalini Rajoo, Director, Commercial Law and Development, Department of Trade and Industry

Lizell Reinecke, Assistant to Shalini Rajoo

William Stacy Rhodes, Director, U.S. Agency for International Development, U.S. AID/ South Africa

Rosie Richards, Service Officer, Citibank, F.S.B.

Jatinder Singh, Regional Head Latin America, Africa, Middle East, DaimlerChrysler Services AG

Andrew Skeen, Professor of Law, Dean of the School of Law, University of the Witwatersrand

Franz Tomasek, CA (SA), Law Administration, South African Revenue Service

Christo F. Wiese, Registrar of Banks, Head: Bank Supervision Department, South African Reserve Bank

Dr. Robert C. Williams, Professor in the School of Law, University of Natal. Consultant to the Team

Richard S. Wilkinson, Executive Director, Institute of Directors in Southern Africa

C. Timothy Wood, Managing Director, Modern Africa Fund Managers, L.L.C.